

## INTERNAL REVENUE SERVICE

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May 2, 2001

[REDACTED]  
United States Senate  
Washington, D.C. 20510

Attention: [REDACTED]

Dear [REDACTED]:

I apologize for the delay in responding to your March 8, 2001 letter on behalf of your constituent, [REDACTED]. [REDACTED] is concerned about the anticipated guidance referred to in Notice 2001-14, 2001-6 I.R.B. 516, published February 5, 2001 (copy enclosed), and is specifically concerned that the Service is improperly imposing a tax and subverting the legislative process. We are pleased to have the chance to respond and believe that [REDACTED] concerns and the allegation in the news clipping referring to the anticipated guidance as a "new official position" are mistaken. Instead we believe the positions reflected in Notice 2001-14, which anticipates guidance that would apply employment taxes to statutory stock options, are grounded in statute. Further, recognizing the concerns reflected in the news clipping, we have invited comments before issuing further guidance, and have made provision for broad transition relief. Below I have detailed my responses to [REDACTED] concerns.

### **Statutory Stock Options**

Notice 2001-14 applies only to employee stock options called statutory stock options. Statutory stock options include incentive stock options (ISOs) described in section 422 of the Code, and options granted under an employee stock purchase plan described in section 423 of the Code (ESPP options). Statutory stock options are given special income tax treatment under section 421 of the Code, so the employee does not recognize income when he or she exercises an option. With other types of employee stock options, an employee generally recognizes income for income tax purposes when the employee exercises the option.

One of the requirements to qualify for the special income tax treatment is that the employee not sell or dispose of the stock before the later of two years from the date the

employer grants the option or one year from the date the employee exercises the option. If the required holding periods are met, any gain realized by the employee upon the sale or disposition of the stock generally will be treated as capital gain. If the required holding periods are not met, however, the taxpayer loses the special income tax treatment under section 421 of the Code. This is referred to as a disqualifying disposition, and the employee recognizes as compensation (and not capital gain) an amount equal to the spread at exercise. The spread at exercise is the difference between the exercise price and the fair market value of the stock when the option is exercised.

Special provisions of the Code apply to ESPP options granted with an exercise price less than fair market value as of the date the employer grants the option. The difference between the exercise price and the fair market value is referred to as a discount. ESPP options may be offered at a discount, if the exercise price is not less than the lesser of:

- (1) 85% of the stock's fair market value at the time the option is granted, or
- (2) 85% of the stock's fair market value at the time the option is exercised.

When an employee receives an ESPP option granted at a discount, exercises the option and disposes of the stock in a manner that meets the holding period requirements, the employee must include as ordinary income for the year of the sale an amount equal to the lesser of:

- (1) the excess of the stock's fair market value at disposition over the exercise price, or
- (2) the excess of the stock's fair market value at the time the option is granted over the exercise price.

### **Application of Federal Income Tax Withholding to Stock Options**

Every employer who pays wages must withhold on such wages for federal income tax purposes. The legislative history of the Code sections requiring federal income tax withholding on an employee's wages states that the purpose of income tax withholding is to enable taxpayers to pay income tax in the year in which they earn the income. An employee does not recognize income when he or she exercises a statutory stock option, and so he or she is not required at that time to include any amounts in income for income tax purposes. Therefore, federal income tax withholding does not apply when an employee exercises a statutory stock option. In contrast, employees must

generally include amounts in income when they exercise a nonstatutory stock option, so federal income tax withholding applies at that time.

Certain circumstances may lead to the realization of ordinary income when the employee sells or disposes of the stock acquired when he or she exercised the statutory stock option. For example, an employee recognizes ordinary income at the time of a disqualifying disposition. In addition, an employee recognizes ordinary income at the time he or she sells or disposes of stock acquired when he or she exercised an ESPP option offered at a discount. When ordinary income is realized, federal income tax withholding applies.

### **Application of FICA Tax and FUTA tax to Statutory Stock Options**

Employment taxes also include the Federal Insurance Contributions Act (FICA) tax and the Federal Unemployment Tax Act (FUTA) tax. The FICA tax and FUTA tax are calculated as a percentage of an employee's wages. For FICA tax and FUTA tax purposes, wages are defined generally as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. In contrast to the Code provisions governing income tax, the Code provisions governing employment taxes do not contain any special provisions addressing statutory stock options. No exceptions exist in the relevant provisions defining wages that exclude from wages remuneration paid in the form of stock; nor are there any provisions that exclude from wages remuneration received from the exercise of a statutory stock option.

Because no Code provision provides for special treatment of statutory stock options for FICA tax and FUTA tax purposes, these taxes apply to statutory stock options just as they apply to any other employee stock options. That is, FICA tax and FUTA tax apply at the time of exercise, with the wages paid equal to the difference at exercise between the exercise price and the fair market value of the stock acquired.

### **Notice 2001-14**

We recently addressed these issues in Notice 2001-14. In the context of that notice, we recognized that the Service's lack of formal ruling guidance on these issues, combined with the earlier guidance on the precursor to section 422 of the Code, had created confusion. Specifically, Revenue Ruling 71-52 (1971-1 C.B. 278) and Notice 87-49 (1987-2 C.B. 355), discussed in the attached notice, led many employers and their advisors to conclude that employment taxes were not applicable to statutory stock options. In light of the confusion, we issued Notice 2001-14, which lays out the statutory scheme applicable to statutory stock options. Notice 2001-14 states explicitly that Revenue Ruling 71-52 is obsolete and does not apply to ISOs or ESPP options,

and that Notice 87-49 is modified to the extent inconsistent with Notice 2001-14. The notice also provides generous transition relief and invites comments both on the analysis and on the transition.

To allow time for the comment period and full consideration of those comments in developing any further guidance, and to give employers time to make any payroll or other recordkeeping adjustments to comply with the guidance, we provide explicitly in Notice 2001-14 that we will not enforce the application of FICA tax and FUTA tax upon the exercise of a statutory stock option that occurs before January 1, 2003. Also we will not enforce the application of federal income tax withholding upon the sale or disposition of stock acquired pursuant to those exercises. In order not to disadvantage employers who applied employment taxes to statutory stock options, employers may apply the notice retroactively, and submit any otherwise allowable claim for FICA tax and FUTA tax adjustments or refunds based on the notice.

### **The Anticipated Guidance**

Notice 2001-14 briefly refers to anticipated guidance that would clarify the application of employment taxes to statutory stock options. Based on the governing statutory provisions, we indicated that we anticipate that the guidance will reflect the broad definition of wages, and the lack of an exception from the definition of wages for remuneration received in the form of stock, including stock received when an employee exercises a statutory stock option. However, Treasury and the IRS believe there may be authority for future administrative guidance to treat as not being subject to federal income tax withholding, amounts realized when an individual sells or disposes of stock acquired pursuant to the exercise of a statutory stock option. As indicated above, the notice request comments on this analysis. The comment period closes on May 7, 2001. Consideration of any comments received will be an important aspect of developing any further guidance. [REDACTED] comments as well as the article he encloses will be included among these comments as we go forward.

I hope this letter is helpful. If you have further questions or would like any additional information, please contact me at (202) 622-6000 or Stephen Tackney (ID # 50-18084) at (202) 622-6040.

Sincerely,

Sarah Hall Ingram  
Division Counsel / Associate Chief Counsel  
Tax Exempt and Government Entities

Enclosure